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Inflation of money is the symptom, inflation of credit is the disease.

— Credit Of The Nations, J.Laurence Laughlin
New York, 1918

BUBBLE FUEL: CREDIT AND DEBT

You can easily tell a doomed "credit bubble economy" from a "new paradigm economy" that has entered an unprecedented "new era" of lasting strong growth with low inflation, justifying unprecedented levels of stock valuations. There is a very simple, straightforward measure: credit expansion! The excessive growth of credit and debt in comparison with the current growth of gross national product is an irrefutable hallmark of a credit bubble economy.

Economic growth has two sources. One is on the supply side of the economy: capital formation providing continuous increases in productive capacity. The other one is expanding demand fueled by credit creation. In the absence of credit excesses, the supply and demand for goods and services tend towards equilibrium as production inherently creates an equivalent amount of income. In a balanced economy, total spending is thus limited by income growth accruing from rising production, not vice versa. However, such economic equilibrium requires that credit expansion be limited to current savings, with interest rates as the equilibrating instrument. Say's Law, from Jean Baptiste Say, 1821, dictates that supply creates its own demand, or rising purchasing power comes exclusively from rising production.

The economic concepts of the "classical economists" - a term Marx invented for the predominant British economists of the early 19th century - were primarily concerned with real capital formation and productivity gains as the one and only true sources of rising wealth and prosperity. Keynes extended the term to cover the economists of his time (Marshall, Pigou, Hayek), whom he fiercely assaulted for their tenacious faith in the ability of market forces to preserve full employment.

All these economists had remained faithful to Say's supply-centered approach. Still they had realized that this principle was increasingly invalidated by the progressive unfolding of "money and credit economies." Rapidly expanding banking systems and the establishment of central banks in the latter part of the last century radically changed the rules of the game. The outgrowth of these new financial systems was a capacity to create vast amounts of money and credit virtually out of the blue, thereby severing the former close connection between supply, income flows and demand in the economy.

In view of this development, these classical economists began to direct their attention to potential disturbances in the financial sector. Characteristically, one of them wrote, money and credit are most unimportant, except when they are out of order. The one thing to be realized in the first instance, in fact, is that any economic shock essentially originates in the financial sphere, given unfettered capability of the system to create credit in excess of savings. As a result, careful and critical observation of the financial sphere became the primary concern of the classical economists. In this way, classical supply-side theory turned largely into classical credit theory, elaborating in particular on two questions:

First, when does a credit expansion become excessive and inflationary? And second, what are the ill-effects of credit inflation on economic and financial structures?

To the first question all theoretical schools had one common, precise answer: credit expansion becomes

excessive when it exceeds available savings. As to the second question, the answers diverged. Most economists emphasized the effects of credit excesses on the price level as indicated in the price indexes. The exception was the Austrian theory. It declares that the price effects were unreliable and that, more importantly, credit excesses had much deeper and fundamental distortive effects on the whole economy, especially on the structure of production.

But all this thinking, all these questions have been largely forgotten, owing primarily to the work of one single man: John Maynard Keynes. With his book "The General Theory of Employment Interest and Money," published in 1936, he stood the supply-centered classical economics on its head, proclaiming the demand-centered credit economy. In Keynes' view, supply and employment are a function of demand and controlled by it. Keynes was the first economist to postulate that money and credit give governments and central banks complete control over economic activity. Instead of seeing any dangers in this elasticity of the financial system, he elevated it to the harbinger of easy solutions for recessions and depressions by easy money and fiscal deficits. While the "classicists" warned of toil and hardship in consequence of past excesses, Keynes promised comfortable redemption, and he won public opinion.

THEY ARE ALL KEYNESIANS

In recent years, it has become fashionable to deride the teachings of Keynes and to implore supply-side economics. In reality, the Keynesian "mind set," among policymakers and economists is more virulent than ever. We have Keynesianism in the extreme. Virtually all of the macroeconomic models that economists, governments and businesses use today for forecasting, planning and decision making are based on assumptions that are Keynesian at root. Even the monetarist school uses exactly the same aggregate premises. What's more, both monetarists and Keynesians believe that governments and central banks exert effective control over the business cycle, except they blunder. Mr. Greenspan and Mr. Rubin, of course, would never blunder.

Frankly speaking, we find it utterly misguided to regard today's prevailing economics—whether monetarism or Keynesianism—as economic theories at all. The essence of any theory is an attempt to explain and to understand the cause of recurring relationships. Emphasis on "explain and understand." The classical economists saw their primary task in two endeavors. The first was to diagnose the causes of economic expansion and crisis; the second, was to explore and weigh the consequences of any events or measures, over both the short run and long run. Actually, investigating the latter was regarded as the most important part. Generally speaking, classical economics was strictly an analytical science.

To quote Ludwig von Mises: "What started economic studies was precisely the fact that some men of genius began to suspect that the remoter consequences of an event may differ from the immediate effects, visible to the most simple-minded layman. The main achievement of economics was the disclosure of such long-run effects hitherto unnoticed by the unaffected observer and neglected by the statesman. From their discoveries the classical economists derived a rule for political practice: In planning and acting. governments, statesmen, and political parties should consider not only the short-run consequences but also the long run consequences of their measures."

Most of the serious errors in economic policy committed by governments do flow from the failure to consider the second-order or third-order effects of policies. All credit bubbles have been wonderful in the short run but have become disasters in the long run. Mr. Greenspan, at least, ought to know this. It was their misgivings about the detrimental long-run effects of expanding government deficit spending that induced the classical economists to oppose Keynes' proposals in this respect.

Keynes himself, actually, developed his own theory of the causes of the world depression. Tracing it wholly to the breakdown of investment throughout the world, he tried to explain that there were forces at work in the financial system which tended to perpetuate the slump by keeping investment spending below savings.

Ergo, his proposals of loose money and deficit spending as a curative. Belatedly, these policy recommendations were extensively exercised around the world in the 1970s and 1980s with the well-known result of "stagflation"—less economic growth but more inflation— exactly what the classical economists had feared.

This brings us to what we regard as the most important difference between past and present economics. As mentioned before, the old economists centered their investigations on causal relationships and longer-term consequences of events, always in search of dangerous imbalances. It was a science of logic. Today's economists are no longer interested in uncovering underlying causal processes or in understanding relationships. Nor do they bother about adverse longer-term consequences. Their fixation is on statistical correlations, which can be captured mathematically, completely regardless of causal connections. In America, in particular, economics today is just a glut of statistics.

The chief business of today's economists is no longer to analyze processes but to forecast, what is going to happen next to the economy and, above all, to the financial markets. As we can attest, any attempt to analyze is ridiculed. Thinking, long-term thinking, in particular, has been completely eclipsed by short-term forecasting. Economics has degenerated into short-term macroeconomic mathematics. For example, Paul Krugman, the eminent MIT economist, recently scoffed at Austrian theory with the argument that it cannot be expressed in math.

CONFUSING DEBT WITH LIQUIDITY

What is most worrying about today's economics, however, is the complete disappearance of credit theory and with it the concept of financial and economic equilibrium. U.S. business and consumer debt virtually exploded last year by almost $1 trillion combined, while personal savings plunged into negative territory. For anybody with a vague sense of the requirements of economic and financial equilibrium, this is a monstrous, unsustainable financial imbalance, essentially heavily unbalancing the whole economy. However, the consensus crowd sees nothing wrong in this. On the contrary, it is hailed for its positive growth effects.

This general unconcern has its obvious cause in the prevailing complete lack of interest in matters and implications of credit and debt creation, for which the American monetarists are manifestly responsible. Postulating that changes in spending are primarily determined by changes in the money supply, the monetarists discarded the development of credit and debt as matters of little or no relevance. Under the monetarist influence, the general focus in monetary matters has shifted towards money as evidenced by liquidity creation. Hence, numerous American economists literally forgot that things like credit and debt exist. Above all, their orientation has completely blinded them to the debt problems that are rapidly accumulating in the U.S. economy. Where others see rising indebtedness, they see nothing but rising liquidity.

Of course, money is important, but credit and debt are far more important. Money creation, actually, is a by-product of one single type of lending, bank lending. Every loan by a bank increases the volume of bank deposits. As the customer draws on his credit line in order to pay for purchases, the recipients register increasing deposits. Thus, bank lending translates into overall deposit money creation.

In support of money supply as the decisive monetary gauge, it has been argued that money supply tends to lead the business cycle whereas credit tends to lag. Maybe, but that counts very little against the fact that credit statistics offer very important insights that the money figures do not. In particular, they tell us about the specific use of credit (for investment, consumption or speculation) and give us insights into these areas as a result. More importantly, we find the basic monetarist concept that changes in spending are primarily determined by changes in the money supply grossly flawed. The regular way for businesses and consumers to increase their spending independently of current income is to borrow. Credit is clearly the prime factor, and money the secondary factor.

Another big source of money pouring into the financial markets over the last few years, moreover, has been a race among investors to get out of existing money balances and into bonds and stocks in search of higher yields. This shift in so-called liquidity preference (Keynes) has certainly played a tremendous role in fueling the bull market in addition to massive borrowing for speculation, but there is no way to measure it since it leaves the money stock untouched. Instead, it increases money velocity. But the effect of this change is also declining liquidity as market values rise in comparison to the money stock.

A chart in the last letter showed that the two broad money aggregates (M2 and M3) have soared ever faster since 1995, apparently perfectly explaining the twofold boom of the economy and the financial markets. But we hasten to add that they were grossly outpaced by another aggregate which we call the prime factor, and that was the far more profligate debt and credit creation. An increase in M3 by $636 billion and of M2 by $381 billion in the course of 1998 compares with an explosive surge in nonfinancial debt of nearly $1 trillion. Now, which of these aggregates is the governing and decisive factor behind the U.S. economic and financial bubble? Money or debt growth? The following table tells you more about it.

GDP, DEBT, MONEY SUPPLY

Increases (in $billion)

						1997*		1998*	
	1991	1994	1995	1996	1997	I	II	I	II
GDP	313.7	388.9	322.6	392.0	449.3	490.0	364.2	372.2	
NATIONAL INCOME	276.4	323.9	333.0	332.3	390.5	461.2	326.8	355.2	
NONFEDERAL DEBT	331.9	416.4	557.1	580.8	745.3	633.8	856.7	977.4	1.1125
FINANCIAL DEBT	294.9	468.4	456.4	556.2	644.4	497.7	790.9	928.2	
BROAD MONEY (M3)	65.4	74.7	262.0	335.5	443.8	356.2	531.4	538.2	437.4
BROAD MONEY (M2)	52.8	15.5	148.2	174.9	220.3	163.8	275.6	299.4	678.0

*Half years, all figures are annualized

Source: Federal Reserve, Flows of Funds; Survey of Current Business

Looking at these figures, we have already pointed out that credit and debt growth has been vastly outpacing money growth. This fact essentially signals a drastic liquidity deterioration. By the same token, it is proof that the U.S. economic and financial bubble is propelled, not by excess liquidity—which in the monetarist concept seems to fall from the sky—but by unprecedented excesses in credit and debt. To really grasp the monstrousness of these monetary excesses, the debt and credit expansion ought to be measured against the current growth of national income and gross national product.

During the first three quarters of 1998, an increase in nonfederal indebtedness by $702 billion coincided with an increase in national income by $240 billion. For each dollar added to national income, $2.92 was added to private debt. Measured against the growth of gross national product, the debt ratio was $2.66 of debt to each dollar of growth. For historic perspective: the mean debt ratio during 1953-80 was $135.70; at year-end 1980, the ratio was $137.10; and at year-end 1989, it was $183.60. Now it is a fantastic $2.92. To rejoice at "excess liquidity" fertilizing the financial markets without even a glimpse at the much faster rising debt curve, is an atrocious lack of thinking.

But why this unusual, huge gap between debt creation and money creation in the United States? It has two major causes. One is the yawning U.S. current account deficit. Involving a corresponding outflow of money in payment for the soaring import surplus, this huge deficit acts as a massive drain on the domestic money supply. To offset this monetary drain and to maintain domestic income and demand growth, more credit must be created. The other cause of the striking divergence between money and credit creation is that an increasing share of credit is now being created outside the banking system, that is through the securities markets and nonbank financial intermediaries.

This shift in credit creation is significant from the monetary point of view because lending through the

latter two channels does not add to bank deposits, the main component of the money supply. Instead, it leads to a more intensive use of the existing money supply, in other words, to increasing money velocity, which has precisely the same effect as an increase in the money supply. These two types of lending create purchasing power just as bank lending does, and this is really the absolutely compelling reason for choosing credit, rather than money, as the crucial monetary indicator.

TRADE TAKES ITS TOLL

But looking at the figures in the above table, still another conspicuous anomaly leaps to the eye. That's an inordinate divergence between exploding debt growth and slowing growth in nominal GDP and income. Since 1994, debt growth has in the United States more than doubled, from $416 billion to nearly $1 trillion, as against just a moderate acceleration in national income growth. GDP growth has even decreased, both measured in nominal terms. Year-over-year growth in nominal GDP dropped in 1998 from 5.9% to 4.5%.

How can one reconcile this weakness in nominal GDP growth with the prevailing perception of a booming U.S. economy, growing "too fast"? Apparently, few realize that the economic strength during the last years, as measured in real terms, was derived largely from falling inflation rates. As a result, declining nominal GDP growth translated into accelerating real GDP.

Is that the influence of deflation? Definitely not. Deflation presupposes credit contraction. But America has rampant credit inflation. No, this divergence between nominal and real GDP growth has one main cause, and that is structural. This structural cause is the rapid growth of the computer industry in conjunction with the dizzying fall in the prices of computer equipment. Since 1995, the production of computer equipment accounts for about one third of real GDP growth. If the computer industry is removed from the calculation of real GDP, economic growth looks pretty subdued. On the other hand, inflation would be much higher. In the third quarter of 1998, plunging computer prices cut the change in the GDP price index drastically from 1.9% to 1%.

Frankly speaking, we had at first some difficulty in reconciling these facts with the ongoing borrowing and spending binge, seeing no letup in this respect. The explanation lies in the fact that a growing part of the accelerating spending has been diverted abroad into soaring imports, at the expense of domestic capacity utilization. But in real terms and in the aggregate, this drain on GDP growth was offset by the computer boom. Any weakness in the U.S. economy, in short, results from the surging trade gap, not from shrinking domestic demand.

IS THERE ANY LIMIT?

We realize that many people worry whether the rampant U.S. money and credit creation might not sooner or later nevertheless translate into faster inflation in consumer and producer prices. No, in the present global and domestic environment it will not, and it cannot. What's more, great financial bubbles of the kind now being blown in the United States do essentially end, and have always ended in deflationary collapses, not inflationary overheating. The reason is that their burst implicitly involves a massive destruction of liquidity and wealth.

Last but not least, we see a difference of crucial importance between government debt and private-sector debt. Government debt has no limit and tends to be monetized. The long inflation of the 1970s and 1980s originated in the monetization of excessive government borrowing in association with wage inflation. But increases in the indebtedness of the private sector, that is of businesses and consumers, have inherent limits, in particular when rising debts are no longer inflated away by rising prices. Excessive borrowing on the part of the private sector relentlessly ends in overindebtedness and bust.

We have to admit that the scale and the duration of the present U.S. consumer borrowing and spending binge have been boggling our mind. But we have realized that the huge capital gains in the stock market have made it self-financing and self-propelling. That's what makes a bubble. In terms of current income, debts are

soaring; but in terms of exploding financial wealth, they are plunging. Debt limits have not been suspended; they have temporarily been stretched.

U.S. consumer indebtedness, we think, has already passed the point of no return. Only the booming stock market is still giving this borrowing binge a temporary lease on life. The signs of growing strain in corporate balance sheets are clearer, though. Rapidly accelerating indebtedness coincided during the last year with virtual stagnation both in profits and internally generated cash flow. Lately, strong investment spending has been one cause of record corporate borrowing. Even more important is financial leveraging through mergers, acquisitions, and surging stock buybacks. In their obsession to boost profits per share and thereby shareholder value, by the by with big profits for themselves, corporate managers are driving financial leverage to unprecedented, dangerous excess. As a result, business investment spending is now just as much in jeopardy as consumer spending.

OUT OF CONTROL

In the second half of 1997, credit expansion in the United States went completely out of control (see the table on page 4). The growth of nonfinancial debt accelerated by more than 50%, while the financial component virtually trebled. As already mentioned, the scale of the credit excesses that have unfolded during the last two years is without parallel in history. But the salient point is that, given sluggish nominal economic growth and falling consumer and producer price inflation, these excesses proliferated overwhelmingly through the financial markets.

There is an understandable penchant to think that price stability tends to be aligned with financial stability. Ironically, this is a great error. Just the opposite is true. Giving the illusion of health and safety, price stability stimulates financial speculation. It is a historic fact that asset bubbles have always and only occurred in times of low or zero inflation. Think of the U.S. bubble of the late 1920s and, more recently, of the Japanese bubble. While this regular coincidence of price stability with financial instability may seem paradoxical, it is perfectly plausible and logical: the low or zero inflation rates are precisely what regularly keeps monetary policy too accommodative for too long.

Next, I'd like to add a few riders. First, with the federal budget in surplus, virtually the whole of the record-high debt creation presently taking place in the United States originates from businesses and consumers. Second, total net flows through U.S. credit markets, financial and nonfinancial combined, have lately been running at a rate of more than $2 trillion. That's a doubling within two years. And, last but not least, this egregious debt explosion has to be seen against currently negative personal savings.

What is behind the extraordinary explosion of the financial sector debt? There are various things, but the biggest items, which account for about 80% of the increase in this component, relate to the purchasing and funding of asset and mortgage-backed securities by government-sponsored enterprises and mortgage pools, among them Freddie Mac and Fannie May as the most powerful players. In past letters, we have several times extensively written about their soaring lending activity.

Our main point is: Don't let yourself be fooled by the rigmarole about "excess liquidity" fueling the boom of the U.S. economy and its financial markets. It's complete nonsense. Their joint propellant is an unprecedented credit and debt binge. It is symptomatic of the prevailing superficiality in thinking about monetary matters that the question of the origin of the soaring money supply and its various implications is neither asked nor discussed. Well, it's all borrowed money and borrowed liquidity with a flip side: a debt explosion that vastly exceeds the increase in liquid assets.

THE REGULAR CATALYST: ECONOMIC WEAKNESS

In the most recent letters, we have repeatedly stressed that the U.S. economy's perceived strength is the chief pillar sustaining the underlying bullishness in the stock markets of America and Europe. If that perception

breaks, it will usher in the Great Global Bear Market in stocks and the dollar. Again and again, it is unexpected economic weakness that shatters currencies and booming stock markets. In 1997, it was Asia; last year, it was Russia, and at present, it's Brazil.

Fueled by rapidly accelerating credit growth, the U.S. economy in the last two years has stayed stronger than we had expected in consideration of the bubble-related imbalances in the economy. Still, we looked for a sudden, surprisingly weakening divergence between nominal and real growth which was more apparent than real.

In this light, we agree very much with what the OECD in Paris says in its latest Economic Outlook about the U.S. economy: "The U.S. economy appears to have reached a cyclical high point in 1998. The year-on-year growth rate peaked at 4.2% in the first quarter. Following a deterioration in corporate profits linked to a strong dollar, accelerating labor costs and lower external demand in Asia and Latin America, economic growth is projected to slacken progressively to not much more than one percent in the middle of 1999 ...With labor costs running ahead of prices, the fall in profits could accelerate, raising the risk of a drop in equity prices and a significant fall in investment."

The OECD expects the United States to post no more than about 1.5% real GDP growth next year, being followed by a slow pickup to 2.2% in the year 2000. The origin of the expected sharp slowdown will likely be a delayed reaction of companies and households to a marked weakening of corporate profits that occurred during 1998. As a result, corporations are expected to scale back investment outlays. In the same vein, consumers will probably increase their savings again in the wake of lower equity values.

THREE POTENTIAL SHOCKS

The OECD cautions, though, that there are overwhelming risks on the downside. It warns that many of these risks could interact in ways that reinforce one another and lead to a substantially different—and more negative outcome. It points to three potential, interdependent risks:

A deepening of the crisis in Asia and a widening to Latin America, reflecting a worsening global credit crunch which leads to further bouts of currency depreciation and shrinking demand in these economies.

Further, a continuing decline in the Japanese economy while bank restructuring there remains stalled will cause the yen to fall and domestic demand and confidence to weaken further.

Finally, another sharp correction in global equity markets along with weakening confidence, which will adversely affect internal demand in the OECD countries. The U.S. dollar will fall under pressure from a massive outflow of capital from the U.S. equity market.

We would say that the possibility that these risks will materialize is high in the next half-year. Besides, we suspect that the growth rates of 1.5% and 2.2% projected for 1999 and 2000, which were forecast even before considering of the risks OECD points out, are already low enough to shock Wall Street into a sharp correction.

AGAIN: EURO VERSUS THE DOLLAR

For the time being, the currency markets are focusing on the apparent weakening of the European economy. It was in particular the striking contrast between news about sharply higher employment in the United States but significantly higher unemployment in Germany that wounded the euro in the currency markets. Earlier expectations that the Fed had intended another rate cut in the near future gave way to speculation that it will keep rates steady for much longer, essentially lending support to the dollar in the markets. Conversely, mounting evidence of a slowing German economy has inspired expectations that the European Central Bank will be forced to ease interest rates before the Federal Reserve.

Markets like to play apparent short-term perspectives. Compare this with an OECD projection of a very sharp decline of the U.S. economy this year to 1.5%, from 3.5% in 1998, as against a moderate decline of the

euro-area economy's growth rate from 2.8% to 2.2%. The worst one can say about Euroland is that its economy lacks thrust; the best thing is that it lacks big financial imbalances and excesses.

Our dollar bearishness, we hasten to add, has nothing to do with bullishness about the euro economy. The causes of the coming dollar weakness lie completely inside the U.S. economy and its financial system, more precisely in the economic and financial excesses and imbalances that have accumulated. Only the timing is uncertain.

END OF THE DOLLAR STANDARD

If nothing else, Brazil's move to freely float its currency has shattered the comforting notion that the world economy is slowly but surely on the mend. After a momentary shock, global stock markets celebrated the news with a strong rally on the hope that it will free Brazil from the need to defend the currency with high interest rates, which would have driven the economy into deep recession.

Immediate events in Brazil, however, hardly give any reason for optimism. Even though the central bank has felt obliged to implement a steep increase of its interest rate, the currency has already plunged about 42%. For the time being the crisis is deepening, with an obvious threat to draw other Latin American countries into trouble. No doubt, the markets are already looking for the next kill. Latin America, for sure, is heading for deep and deepening recession.

Yet there is still another important aspect. It concerns the global currency regime: The plunge of Brazil's real is probably the last nail in the coffin of the international dollar standard. When in the early 1970s, the industrial countries decided let their currencies float, the developing countries successively choose to peg their currencies, more or less adjustable, to the dollar as their anchor currency, establishing among themselves the dollar standard. As this implied that central banks held all their currency reserves in dollars, this certainly helped to strengthen the dollar. Conversely, the discontinuation of the peg reduces or removes the necessity to hold dollar reserves. The dollar standard ends. In the last analysis, it has blown up because money and credit in the key country has been much too loose.

Speaking of measures to solve the crisis of the emerging countries, we have to admit that for our taste there is far too much talk of restoring confidence and capital flows and much too little about necessary adjustment. It was clear from the beginning that the fate of each emerging country would crucially depend on its ability to export itself out of its troubles. But that depends also on the willingness and ability of the industrial countries to accommodate those exports. That's what America did last year with its import boom, reflecting the domestic spending boom. According to OECD calculations, positive trade effects added last year about 5% to the GDP of the emerging countries. And what about 1999? This is for us the most important question. We fail to see the United States making a further accommodation.

TULIP.COM

In the December letter we discussed how an unprecedented flood of new bank credit and money creation had heroically rescued Wall Street. Well, America's almighty credit machine continues to fire on overdrive as a stock market recovery transcends into an historic and record-setting advance, replete with truly breathtaking speculative excess. Even as bank credit growth has slowed somewhat from an unsustainable rate of more than 20% in October, the money fund expansion runs unabated. For the past 15 weeks, money market funds assets increased $150 billion, or at an annual rate of better than 40%. During this period, M3 money supply likewise expanded parlously by $212, an alarming 14% annualized rate with fully 70% of this record growth explained directly by the surge in money market fund assets.

Not surprisingly, the money market explosion remains undeniably correlated to the ballooning balance sheets of Fannie Mae and Freddie Mac. For the fourth quarter, frenetic and truly stunning growth continued

with Fannie expanding its mortgage portfolio by a record $30 billion, or at a 26% annualized rate, and Freddie an astonishing $58 billion, or 88% annualized. For all of 1998, Fannie and Freddie puffed up their balance sheets $220 billion, or almost 40%. Just compare this with GDP growth of close to $400 billion.

THE TEFLON MARKET

As the incredible stock market bubble deflects a long and imposing list of negative factors both globally and domestically, ebullient American analysts have coined it the "Teflon market." Alas, a new degree of American complacency! The European press, on the other hand, displays much more skepticism and alarm, referring instead to "Greenspan's Asset Markets." Sharing our view, a recent Financial Times article discussed factors behind high stock prices, stating, "a big part must be the conviction that they are underwritten by the Fed in order to sustain the expansion in domestic demand." Unfortunately, the high—and we would say absolutely unacceptable—price for such excess is inarguably the greatest speculative mania and economic bubble in history. Certainly assisting the Fed's immediate crisis management efforts but, at the same time, creating a momentous dilemma going forward, investors interpreted the Fed's aggressive move of heightened accommodation in the face of an explosion of money and credit growth as clear evidence that monetary policy is firmly focused on sustaining the stock market bubble.

And as a new-fashioned, visceral bout of irrational exuberance and unprecedented speculation runs unabated, the NASDAQ100 and Morgan Stanley High Tech indices have gained almost 150% since Greenspan's salient warning two years ago. For 1998, the NASDAQ100 gained 85%. The S&P 500 had a 1998 gain of 27% and, with earnings posting a decline for the first three quarters of 1998, the S&P500 price-to-earnings multiple has surged to 33 after beginning the year at 24. Nowhere, however, is the mania more apparent than in the Internet stocks where The Street.com Internet Index has a 52-week gain of 200%, despite the absence of either earnings or dividends. Comprised of 20 stocks, only four have 52-week gains of less than 100%; six recorded increases of more than 500%; seven surpassed 200% and two amassed greater than 100% gains. Moreover, the combined market capitalization of four Internet companies, America Online, Amazon.com, Yahoo!, and eBay now approaches $123 billion. Twelve-month revenues for these four totaled $3.5 billion.

But a shameless Wall Street eagerly declares that speculation is present only in a limited "handful" of stocks. The Interactive Week Internet Index comprised of 50 stocks and with a market capitalization of more than $500 billion has a 52-week gain of 167% and a P/E ratio of 510. Fully 32 stocks within this index have more than doubled in price this past year, while only about one in 10 reported profits. As the mania runs throughout the technology sector, the Morgan Stanley High Tech index comprised of 35 leading companies has a 52-week gain of better than 115% with a P/E ratio surpassing 93. The composite of the 100 largest NASDAQ companies with a market capitalization of $1.7 trillion, now trades with a multiple of price-to-earnings ratio of 107. The NASDAQ Telecommunications Index comprising 170 companies, which in aggregate operate at a loss, nonetheless has a 77% gain for the year and a market value of $316 billion. And the 10 largest telecommunications stocks have a market capitalization of more than $1 trillion, or about 50 times earnings, adding almost $425 billion in market capitalization the past year. Such valuations are too uncomfortably reminiscent of Tokyo in 1989.

Speculative excess is broadening and escalating as never before. Individual stocks and groups have in the past repeatedly experienced spectacular speculative runs, ending in painful busts. Generally, however, the most intense speculative excess was at a limited scale, largely at the periphery. Looking back, this was the case with many biotechs, riverboat and casino gaming companies, subprime lenders, Wall Street security dealers and scores of speculative small cap stocks, usually with large short positions. And, as one wild speculative frenzy fizzled and fell out of favor, a new and greater one was targeted for the next round.

Now, with the dynamics of speculation empowered from years of ever-greater degrees of excess (not to mention Federal Reserve accommodation!), with each successive round an escalation from the one before, we find the market in the midst of a most dangerous manic episode. Indeed, a monumental speculative melee has reached the very top of the food chain, infecting the largest, most widely held and actively traded stocks in the marketplace.

ONE BIG CASINO

In addition to the more than 5,000 mutual funds, thousands of hedge funds, institutional investors, Wall Street trading desks, and millions of traditional brokerage accounts, the market now has the active participation of almost 5 million new on-line trading accounts recently joining the fray. And with online accounts active traders in the options market, option exchanges report record volume. With this latest development, we can conclude that the transformation is now complete; the entire stock market is but one packed and spirit-stirring casino. With CNBC on television, Bloomberg radio broadcasts, internet stock trading "chat rooms" and live stock quotes easily available online, truly all that is lacking are the flashing neon lights and the clatter of slot machines! In a recent pitiful example of how out of control the situation has become, unsuspecting online investors placed market buy orders for an internet IPO priced at $9, only to be filled at the opening price of $90. For another gross example of mania run amuck, Amazon.com, with weekly revenues of just over $10 million, now consistently trades as one of the most active stocks as weekly dollar trading volume surpasses $10 billion. Gaining almost 1,000% this past year, the company is not expected to show profits for years, but still trades with a market capitalization of $20 billion.

Ominously, today's grossest speculative excesses lie not with internet stocks as many presume, but instead with the largest and most actively traded NASDAQ companies, Microsoft, Intel, Cisco, Dell, and Worldcom. The "Big Five" now command a staggering market capitalization of more than $1 trillion or more than 12 times revenues of $80 billion. Microsoft, with 52-week gains of more than 130% and the largest market value of any American company in history at more than $400 billion, now trades at 27 times revenues. Intel, the "worst" performing of the "Big Five" stocks with a gain the past year of 80%, has a market value of $230 billion despite sharply lower 1998 earnings, trading at 10 times book value and 39 times earnings. Cisco Systems, with a 52-week rise of 170%, trades with a $170 billion market value, more than 80 times earnings, 19 times revenues and 21 times book value. Worldcom, despite never showing much in the way of profits, has a 145% gain, trades at 9 times revenues and with a market capitalization of $142 billion. Dell Computer, with a 52-week gain of 260%, trades with a market value of $105 billion, 82 time earnings, and 56 times book value. For comparison, the market values Caterpillar at $15 billion, Boeing at $32 billion and General Motors at $55 billion

After beginning 1995 at 400, the index of the 100 largest NASDAQ stocks now surpasses 2000. Moreover, from lows on Oct. 8, this index has exploded, gaining more than 90%. And with the large NASDAQ technology stocks widely held by investors and speculators alike, this is much at the heart of the so-called wealth effect. One only has to consider the remarkable economic booms in Seattle and Silicon Valley to appreciate the impact. It is worth pondering, however, the ramifications for both the stock market and economy of a NASDAQ 100 downturn to a not unreasonable multiple of 20 times earnings and, with this, the disappearance nearly $1.4 trillion dollars of market value. This simple analysis, though, assumes that earnings do not collapse as well.

But hot speculation is not limited to NASDAQ. Compaq Computer, despite a collapse in PC prices and earnings, has a 52-week gain of 60% this year; IBM has risen 80% and now trades at almost 10 times book value and a dividend yield of .5%; Lucent, having a 52-week gain of 185%, now trades with a market value of $152 billion and a P/E of 150; and Texas Instruments, despite earnings for the first three quarters of 1998 running at a fraction of last year, has surged more than 115% the past year.

Astonishing price gains, however, are not at all limited to the technology sector. High-risk credit card

lenders have had huge runs the past year with Providian Financial rocketing 175%, trading with a P/E of 46 and 16 times book, and Capital One Financial surging 120%, trading at more than 30 times earnings. Looking at retailers Wal-Mart and Home Depot, their stocks have nearly doubled the past year. Wal-Mart now has a market value of more than $180 billion, trading at 44 times earnings and 9 times book. Home Depot's market capitalization is $90 billion, with multiples of 56 times earnings and 10 times book value. Computer and electronics retailer Best Buy has a 52-week rise of 260%, office supplies seller Staples 150%, and clothing retailer The Gap 120%. Indicative of interrelated financial and economic bubble distortions, the S&P Retail Stores Index, comprised of 38 companies, has a 52 week gain of 55% and now trades with a market value of $645 billion and 33 times earnings. This index, also, has more than doubled since Mr. Greenspan's "irrational exuberance" speech.

There is, however, more here than just unbridled Wall Street hype and speculation. Interestingly, all of the stocks we have previously mentioned have one important factor in common, large short positions and actively traded derivatives. Our analysis leads us to believe that the past several months have witnessed a massive derivative related market dislocation and the greatest short squeeze of all time. We hasten to add that, as students of financial history are well aware, the 1920's stock market bubble reached its zenith in 1929 with a final spectacular rally that largely wiped out the bears only weeks before the great crash.

SOPHISTICATED STRATEGIES RUN AMUCK

Similar to this summer's sharply expanding interest rate spreads and market dislocation, the consequence of forced unwinding of unsuccessful credit market positions by hedge funds and other speculators, today's "melt-up" in many stocks and groups is much the result of sophisticated strategies gone terribly awry. Specifically, we point blame to the widespread use of "market neutral" strategies where players are aggressively long individual stocks or groups matched against short positions. We also suspect derivative strategies for both hedging and speculating purposes were utilized heavily during the previous period of market turbulence, only to be unwound frenetically with the Greenspan rally. And clearly, the bears have been mauled and forced to cover after placing aggressive bets this summer when it appeared a market debacle was imminent.

Not coincidentally, many stocks with the greatest recent advances have huge short positions. Looking at short positions that were in place this past summer, Microsoft had 36 million shares shorted, Intel 26 million, Cisco 28 million, and Dell 56 million. The losses on just these four short positions during the recent rally are nearly $7 billion. Elsewhere, Yahoo, with an 11 million share short position, rallied more than 300 points since early October, and America Online, with 35 million short, surged 120 points. An historic short squeeze developed in Amazon.com, where a split-adjusted short position of 21 million, or fully one in four freely held shares or "float," was decimated as the stock rallied from an Oct. 8 low of $27 to a high of $199.

The most devastating "squeeze," however, was likely inflicted on the semiconductor bears. Micron Technologies, a perennial favorite of the bears with a short position of 35 million shares, rocketed from an October low of 24 to trade at almost 80. Because of dire industry fundamentals, semiconductor companies have been actively targeted by the bears for short positions and by the hedge funds that placed highly leveraged bearish derivative bets on both individual stocks and the semiconductor index. Actually, it had become common practice to write, or sell, call options on this sector, profiting handsomely month after month by pocketing the large call option premiums. But with the semiconductor index surging an unbelievable 125% from October lows, this strategy has led to an absolute debacle.

Today market players firmly view the Fed as determined to perpetuate the U.S. bubble; seeing Greenspan, as we do, absolutely terrified of the consequences both domestically and internationally of squelching America's runaway speculative and credit excesses. And yes, it was Greenspan's determined rate cuts that incited a

speculative buying bonanza as well as a pell-mell stampede of short covering and derivative unwinds, a potent combination of rocket fuel for the stock market.

Importantly, derivatives and sophisticated trading strategies incorporated by the leveraged speculating community have once again backfired, fomenting chaotic trading and market dislocation. As we have written in the past, derivatives create great leverage, stoking rallies on the upside but holding the potential to later feed selling on the downside. We suspect that the recent rally has forced the hedge fund community to dramatically reduce short exposure. Furthermore, we presume the addition of significant derivative related leverage with the bull run. Both of these factors only heighten the market's vulnerability to a sharp reversal as well as posing significant risks of heavy self-reinforcing selling come the next market downturn

In the final analysis, we can not imagine a more destructive scenario than what has actually transpired. In the face of the greatest global financial and economic crisis since the 1930's, Wall Street has taken yet one more wild run to unimaginable excesses. To this, the U.S. economy and financial system are left unprotected. Unfortunately, when this historic fiasco comes to an end, the wreckage will include a financial system and economy hopelessly impaired for years to come.

CONCLUSIONS

The main economic query for 1999 does not concern Europe, Japan, Asia or Latin America. It concerns the U.S. economy and the U.S. stock market.

The U.S. economy has entered 1999 with considerable momentum at the consumer level, but this momentum comes from unprecedented credit and debt excesses that make both the economy and the stock market highly vulnerable.

The Brazilian turmoil is not the beginning of the end of the global financial and economic crisis, but rather, the end of its beginning. Everywhere, recent economic growth is weaker than expected, except so far in the United States.

It is amusing, when American commentators argue that the ailing emerging countries have been living "beyond their means," running up excessive foreign debts. It doesn't occur to them that the worst culprit in this respect is their own country, hailing the same as a virtue.

Any significant slowing of the U.S. economy will come as a shock to the U.S. stock market. It is the most probable catalyst for the final big bear market that we expect.

Once more, Mr. Greenspan expressed warnings that he will not bail out the stock market. But the further the stock market rises, the greater is the prospect that the Fed will be forced to act, when equities tumble.

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